



April 3, 2009

Mary Rupp
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Comments on Advanced Notice of Proposed Rulemaking for Part 704

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)¹ appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) concerning NCUA's Advanced Notice of Proposed Rulemaking (ANPR) on Part 704, Corporate Credit Unions.

These are extraordinary times. A number of corporate credit unions have experienced a dramatic reduction in the value of their investment portfolios, resulting in startling losses. These losses, and the fact that in many cases the markets for trading in certain types of securities have virtually ceased to exist, have undermined the stability of some parts of the corporate credit union network. In analyzing the status of the corporate credit union system, it is vital to determine the extent to which the structure of the system, embedded concentration and systemic risk, and supervisory or risk-management deficiencies contributed to losses in the system.

NCUA Stabilization Efforts

In January 2009, US Central Corporate Federal Credit Union (USC) notified the NCUA of an other than temporarily impaired (OTTI) loss of \$1.2 billion. In response, the agency took several actions to "stabilize the corporate credit union system."² On January 28, the agency announced its actions including: the issuance of a \$1 billion capital note to USC to provide reserves to offset anticipated realized losses on some mortgage- and asset-backed securities; the establishment of a guarantee program of all uninsured shares at all corporate credit unions through February 2009; the establishment of an extended voluntary guarantee program of uninsured shares at corporate credit unions through December 31, 2010; the declaration of a premium assessment to restore the National Credit Union Share Insurance Fund (NCUSIF) equity ratio to 1.3 percent (to be

¹ NASCUS is the professional association of the 46 state credit union regulatory agencies that charter and supervise the nation's 3,300 state-chartered credit unions.

² NCUA, *Board Approves Corporate Stabilization Efforts*, January 28, 2009.

collected in 2009); and an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on needed regulatory and structural changes to the corporate credit union system.

In addition on March 20, 2009, the NCUA, citing agency concerns that “unacceptably high concentration risk” resided primarily in USC and Western Corporate Federal Credit Union (WesCorp) and that deteriorating securities held by the two corporates were contributing to diminished liquidity and payment system capacities, placed both into conservatorship.³

NASCUS continues to study the above mentioned actions and consider the numerous, and complex, interrelated issues confronting the credit union system. NASCUS members believe that changes must be made in both *how the credit union system conducts business* **and** *how the credit union system is supervised*. In brief, NASCUS comments suggest NCUA:

- Resist a rush to judgment on restructuring the corporate credit union system.
- Explore whether lack of proper application of regulation and oversight, at both the state and federal level, contributed to the current events.
- Avoid labeling all credit unions as unsophisticated by unilaterally declaring some activities as too complicated and risky for any credit union.
- Preserve the equal opportunity for all corporates to compete as ongoing concerns as long as they remain safe and sound and retain the support of their members.
- Preserve dual chartering and recognize state authority.

The NCUA’s ANPR is far ranging. Given the information available at the time, NASCUS chose to concentrate its recommendations on several broad areas where general consensus exists among our members. We respectfully reserve the right to expand and refine our comments on the full range of issues as NCUA’s rulemaking process continues.

The Corporate Network

- Corporate credit unions, while belonging to a network, are individual entities. As such, each corporate credit union that is financially sound, and retains the support and confidence of its membership, deserves an equal opportunity to continue as an ongoing concern.

The corporate credit union network (Network) was developed several decades after the states began chartering and regulating credit unions and predates the NCUSIF. The “pre-network” genesis dates back to the 1930s concept of central credit unions with the modern Network taking on its present form in the 1970s. The Network was developed by natural person credit unions to provide correspondent services for credit unions. Within prudent regulatory parameters, the Network belongs to the credit union system, and it is ultimately the natural person credit union community that should decide its scope, function and place, within the aforementioned regulatory parameters.

³ NCUA, *NCUA Conserves US Central and Western Corporate Credit Unions*, March 20, 2009.

Today, 28 corporate credit unions serve approximately 8,000 natural person institutions.⁴ Historically, corporate credit unions have provided credit unions with payment and clearing services, access to money transfer services such as wire facilities and automated clearing house transactions, and investment services. In addition, the corporate network has served as an important source of liquidity for credit unions and as agents on behalf of NCUA's Central Liquidity Facility (CLF) in connection with loans funded by the CLF. Corporate credit unions have also provided other operational and educational services to the credit union system.

As regulatory and operational changes for the Network are considered, it is important to acknowledge that while the 28 corporate credit unions are discussed as a Network, they are individual corporations. Each corporate credit union has its own governance, risk profile and risk management practices. Any regulatory reshaping of the Network and the credit union system must be carefully enacted so as to allow any well run corporate to adapt to changes in the marketplace on its own terms. The credit union system itself conceived and developed the Network. If it becomes in the best interest of the system to dramatically change the Network, natural person credit union owners of the corporate can, and should, determine which corporate credit unions continue as ongoing concerns. Ultimately, the unimpaired capital of any given corporate credit union belongs to its natural person credit union members.

Reasoned Approach

- Until there is a thorough and public analysis of the contributing factors to the startling losses, the system should be wary of a rush to judgment and change.
- State and federal regulators should have a candid discussion of how both regulatory systems may have identified concerning trends for more timely regulatory intervention to address possible systemic flaws.

NCUA stated that the steps taken in January 2009 were essential to stabilize the corporate credit union system. NASCUS understands that regulators are often faced with difficult decisions in time sensitive situations requiring un-popular actions. All regulators, state and federal, have an obligation to carry out their statutory responsibilities as duly authorized.

However, as efforts to stabilize the system and prepare it for the future continue, NASCUS cautions against a rush to judgment in enacting significant changes to the Network and to the natural person credit union system without thorough consideration. While acknowledging that the ANPR is merely the first step in what can be a drawn-out rulemaking process, NASCUS remains concerned that specific changes are being suggested without a clear and reasoned study of what flaws exist. NCUA did retain PricewaterhouseCoopers, LLP (PwC) to audit the corporate system and evaluate ways to stabilize and improve/realign the Network. As NCUA noted in its press release accompanying the March 2009 summary of the PwC report:

⁴ There are 14 state-chartered retail corporate credit unions, 13 federally chartered corporates, and one wholesale federal corporate credit union.

“The PricewaterhouseCoopers LLP confidential report followed a thorough analysis and input from all sources with critical knowledge of the corporate credit union system,”⁵

However, the summary of PwC’s conclusions is of minimal value for those seeking to analyze and contribute suggestions to improve the corporate system. While PwC claims to have prepared the report from “sources with critical knowledge,” to NASCUS’ knowledge no state regulators with corporate credit unions were interviewed for the study. That hardly gives confidence that the full range of perspectives on the corporate system was utilized or the full range of contributing factors considered.

NASCUS believes state agencies and the federal regulator need to discuss regulatory oversight that allowed for concentration and systemic risks to go unchallenged by many in the state and federal regulatory agencies.

In short, there are many contributing factors to the events resulting in NCUA’s stabilization efforts within the Network. NASCUS cautions against a rush to judgment in enacting significant changes to the Network and the natural person credit union system. NASCUS urges NCUA to immediately request the NCUA Office of Inspector General conduct a Material Loss Review to identify all the contributing factors leading to the material losses requiring recapitalization of USC and then conservatorship of the two largest corporate credit unions.⁶

To be clear: thorough review of the Network, the natural person system and the roles of state and federal examiners may result in a conclusion that far reaching structural changes are needed. In that event, NASCUS and state regulators are prepared to work with NCUA to move boldly to make appropriate regulatory and supervision changes to address material safety and soundness weaknesses in the system.

Concentration and Systemic Risks

- The mere presence of concentration risk alone should not necessarily be cause for reshaping the corporate system.

The fact that in many respects, the OTTI-related losses that will now impact credit union balance sheets are a result of an extraordinary economic downturn and the convergence of factors that have devalued otherwise performing bonds, provides little comfort. Simply put, the economic downturn exposed weaknesses in the credit union system and economic downturns are cyclical.

The events precipitated by the write-off (and now conservatorship) at the wholesale corporates verify that as currently structured, operated and regulated, the Network represents both a concentration risk and a systemic risk to the overall credit union system. The concentration risk

⁵ NCUA, *NCUA Releases PricewaterhouseCoopers Corporate CU Report Summary*, March 10, 2009.

⁶ (j) Review Required When Fund Incurs Material Loss.—For purposes of determining whether the Fund has incurred a material loss with respect to an insured credit union (such that the inspector general of the Board must make a report), a loss is material if it exceeds the sum of—(1) \$10,000,000; and (2) an amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance under section 208 or was appointed liquidating agent.

manifests itself both at the natural person level and at the corporate credit union level. At the natural person level, many credit unions had overwhelming concentration of their funds in their corporate. In turn, several corporate credit unions had their funds concentrated in the wholesale corporate. For example, at the end of 2003, the Government Accountability Office (GAO) reported that 17 retail corporate credit unions had at least 70 percent of their total investments and four had at least 60 percent of their total investments, in accounts at the wholesale corporate.⁷ Clearly, these credit unions are inordinately reliant upon the stability of the upstream institution.

That so many natural person credit unions are heavily concentrated in retail corporate credit unions and as that those retail corporate credit unions are invested with the wholesale corporate creates the systemic risk. The disorderly failure of the wholesale corporate would be a triggering event resulting in cascading failures throughout the system.

In addition, the Network represents another form of concentration and systemic risk: the fact that for many natural person credit unions, the retail corporate represents not only a source of investment risk, but also a critical third-party service provider for processing.

The credit union system is a cooperative system. Given the nature of a system that is intertwined from an investment, servicing and insurance perspective, there will be inherent systemic risks and invariably concentration risks. However, this need not necessarily result in a conclusion that the system is untenable: rather, mitigation of the risk within the cooperative structure should be refined.

Systemic Risk Oversight

- Systemic and concentration risk can be mitigated.
- NCUA should partner with state regulators to create a joint systemic risk examination team.

As noted earlier, there are many factors that converged to contribute to the current status of the corporate credit union system. State and federal credit union regulators must candidly and critically review their agencies' performances. Certainly, some state and federal regulators allowed growth assumptions and optimistic ratings and forecasts to outweigh basically accepted principles of concentration risk and shock testing.

However, not all in the system had a homogenized view of risk levels. Just as there are many natural person credit unions that do not have a concentrated exposure with a retail corporate; and just as there are well run retail corporate credit unions that have solid balance sheets (pre-conservatorship loss of their paid-in and member capital) and currently have no OTTI assets; there were regulators who expressed concern regarding risk concentration.

⁷ Government Accountability Office (GAO). (2004). *Corporate Credit Unions: Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight* (GAO-04-97)(p. 85).

NCUA and state regulators should immediately move to create a joint examination team: the Systemic Risk Examination Team (SRET). This team would be comprised of NCUA examiners and at least two state examiners. The state participants would serve overlapping defined terms to ensure both a periodically refreshed perspective with a continuity of experience.⁸ The function of the team would be to annually examine any wholesale corporate as well as periodically examine any other corporate, state or federal, where it is determined a material systemic risk is present. The results of SRET exams would be shared between NCUA and state regulators.

The creation of a team to examine institutions representing a unique material systemic risk would be an important step to safeguarding against regulatory complacency. Further, by its very nature, systemic risk presents all regulators with challenges, even those without direct jurisdiction over the entity representing the risk.⁹ By drawing on the expertise of many regulatory agencies, state and federal regulators could improve their ability to detect and address situations before they achieve critical mass. This ability would present the credit union system with an opportunity to remain a cooperative system that can develop, provide and access its own services while maintaining economies of scale that make those services available to credit unions of more modest means.

Capital and Payment Systems

- Corporate credit unions must retain higher capital reserves including risk-based capital.
- Rather than separating payment services from other services, any corporate should be required to mitigate risk and reserve appropriately for the activities in which it is engaged.

Corporate credit unions must have increased levels of capital reserves. Given the events of January and March, 2009, this should not be a controversial proposition. NCUA should work with state regulators to develop more comprehensive capital requirements, including risk-based capital, for all corporate credit unions. The regulatory capital program should consider the institution's status as a wholesale or retail corporate, its mix of products and services (investment, payment systems, pass through, etc.) and establish parameters of actions for state and federal regulators if capital falls below defined thresholds.¹⁰

The ANPR questions whether retail corporate credit unions should be chartered in a manner as to limit their activities to a specific payment services charter or investment services charter. As discussed more fully elsewhere in this letter, NASCUS questions the authority of NCUA to dictate the charter for a state corporate credit union. However, NASCUS also questions the practical application of such a solution.

⁸ NASCUS leaves to NCUA the make-up of its participants.

⁹ NCUA itself has acknowledged the indirect concern and importance of oversight of non-jurisdictional entities in its CUSO rule.

¹⁰ It is significant that Congress specifically mandated NCUA consultation with state regulators when developing PCA for natural person credit unions. 12 U.S.C. 1790d [216] (1)(1) . Public Law 105–219, Credit Union Membership Access Act (August 7, 1998) amended sections 102a(b), 109, 202(a)(6), 202(b), 202(c), 202(h), 205(b), 206(h), 206(k), and 207(a); repealed section 116; and added new sections 107A and 216.

There is a lack of consensus on whether a “payment system only” corporate credit union could generate enough revenue to support the operations and reserve capital to provide a regulatory safety and soundness buffer. An alternative is to require retail corporate credit unions to maintain sufficient reserves relative to their specific operations. Further, natural person credit union due diligence responsibilities requires a risk assessment and contingency plans for any third party service provider.¹¹ These existing rules should be more rigorously enforced so as to provide regulators greater flexibility to act when a corporate credit union, including one involved in providing critical payment processing, presents an unacceptable risk to the NCUSIF and the credit union system.

Investment Authority

- It is not the particular investment activity, but the manner in which it was conducted that should be at issue for regulators.
- Investment authority for state-chartered credit unions is a matter of state law, and that should be re-extended to the corporate system.

Given the effect of the write-down in investment portfolios of some corporate credit unions, calls to further restrict investment authority for the Network are understandable. However, rather than conclude certain investment authority is too inherently risky for all corporate credit unions, the better approach would be to ask *what risk management policies should have been in place for any given investment strategy*. For example, was too much emphasis placed on external risk rating firms and structural rating enhancement features, which may have disguised the portfolios’ overall risk representation, to the detriment of structural security analysis and vigorous stress testing? Or, as suggested above, were investments overly concentrated in violation of basic regulatory principles?¹²

Overly restrictive investment authority is no substitute for sound risk management and vigorous supervisory oversight. Such authority may, by creating a false sense of security, lead to the very complacency toward fundamental concentration risk principles that failed the system in the current situation.¹³ Further, while it seems counter-intuitive given the current circumstances, regulators should consider allowing greater investment authority for natural person credit unions rather than limiting corporate credit union investment authority. As currently structured, the regulatory system funnels credit union investments into the corporate system, escalating the concentration and systemic risks. By allowing well capitalized, well managed and sufficiently experienced natural person credit unions full investment authority, NCUA could reduce systemic

¹¹ NCUA Letter to Credit Unions 07-CU-13, Supervisory Letter-Evaluating Third Party Relationships, 12/2007, and Supervisory Letter 07-01 (hereafter LCU 07-CU-13).

¹² NCUA Corporate Credit Union Guidance Letter No 2007-02, April 18, 2007 citing corporate credit union exposure to securities collateralized by real estate as 75.34% of all marketable securities.

¹³ Part 704.6(c)(2)(iii) Credit risk management, even expressly excludes from concentration limits aggregate investments in corporate credit unions.

risk: in some cases the investments would be isolated on a natural person credit union's balance sheet.¹⁴

For corporate credit unions with adequate safeguards in place, a full range of investment authority would allow them to make investment opportunities available to credit unions lacking the resources to manage the portfolios day-to-day. However, consistent with NASCUS' comments throughout this letter, it is expected that regulators would require the natural person credit unions engaging a corporate credit union for investment purposes to have sufficient expertise to manage the third-party relationship, understand the associated risks and mitigate those risks consistent with existing regulatory guidance.¹⁵

Regulators should focus on ensuring any credit union, natural person or corporate, has robust risk management and mitigation policies in place to balance its investment portfolios. Such policies should include adequate reserves, requisite expertise, meaningful shock testing and valuation mechanisms, and concentration limits. Credit unions unable to meet these criteria appropriate for their investment activities would not and should not be permitted to engage in those activities.

Field of Membership and Board Governance

- The extent to which FOM or expertise of the corporate boards contributed to the current situation is debatable.
- FOM and governance for state-chartered corporates are properly left to state law.

The ANPR raises questions regarding potential changes to corporate credit union fields of membership (FOM) and board governance. NASCUS is not persuaded by the evidence in record that FOM or general board make-up led directly to the safety and soundness issues at hand. Further, NASCUS questions NCUA's authority to limit state-chartered corporate credit union FOM *or* to limit state-chartered natural person credit union participation in a corporate based on the corporate's FOM.¹⁶ Likewise, the composition of a state-chartered corporate credit union's board of directors is a matter of state law and regulation.

In addition to questions regarding the extent of NCUA's authority to define a state corporate credit union's FOM or composition of the board, NASCUS has serious doubts that the changes proposed would make a material difference from a systemic risk perspective.

Given that the system currently presents concentration and systemic risk, it is unclear how further consolidating the Network would reduce, rather than exacerbate, concentration and systemic risk. It may be argued that reducing the number of corporate credit unions would increase the remaining corporate credit unions' ability to attract and retain regulatory capital as a result of increased natural person credit union membership (as the number of corporate credit unions declined, the capital would theoretically flow to the remaining corporate credit unions).

¹⁴ NASCUS notes that investment authorities for state-chartered natural person credit unions are properly recognized by NCUA as a matter of state law.

¹⁵ LCU 07-CU-13.

¹⁶ NASCUS takes no position on federal corporate credit union FOM.

As noted however, this does not address the concentration risk or the systemic risk (as demonstrated by the conservatorship of WesCorp).

Any risk mitigation achieved by eliminating corporate credit union competition (a presumed by-product of the desire to limit FOM) could very well be offset by the loss of competitive innovation. NASCUS is also uncomfortable with defacto “imprisoning” natural person credit unions within their regional designate corporate. Natural person credit unions should be free to seek out the corporate that offers the best product, service and management.

Finally, from a practical matter, how would the surviving corporate credit unions be chosen? Who would choose them?

Proposals for streamlining corporate credit union boards prove similarly problematic. Corporate credit unions and many natural person credit unions are sophisticated financial institutions. Several states have training requirements for directors and NASCUS has long advocated increased board training. The ANPR also seeks comments on director compensation, term limits and transparency regarding compensation. NASCUS notes that several states allow director compensation and that state-chartered credit unions complete the IRS Form 990 and thereby already make public required information regarding directors and compensation.

However, NASCUS cautions that director requirements alone will not necessarily provide safeguards against the weaknesses identified by the current situation. The wholesale corporate had “outsiders” on its Board, and many “experienced” and “qualified” individuals served on corporate boards for Wall Street firms that no longer exist.

In short, no level of qualifications is a talisman against imprudent risk taking.

NASCUS has long supported efforts by state and federal regulators when credit union boards inherently presented conflicts of interest and interlocks. In those cases, the immediate safety and soundness concerns and prima facie fiduciary duty issues presented a more compelling nexus for regulatory intervention. This is not that case.

Transparency

- Given the magnitude of the losses, the cost to the stakeholders, and the drastic responses being considered, NCUA owes the entire system more transparency.
- NCUA must recognize the role of state regulators and be more forthcoming with their regulatory partners.

State regulators occupy a special niche within the credit union system. As partners with NCUA in the oversight of natural person credit unions, and 14 retail corporate credit unions, state regulators are essential elements of proper oversight and invaluable players in any reorganization going forward. NCUA must recognize the proper role of state regulators, and be more transparent with their regulatory partners.

With regard to the overall system, NCUA should be more transparent with all of the stakeholders. NASCUS does not expect, nor is it appropriate, for a regulatory authority to divulge confidential examination information. However, NASCUS believes more information in the aggregate should be made available. NCUA should re-evaluate the quality of the information being shared with stakeholders. In order to properly plan, credit unions deserve a forthright assessment of the costs they will be asked to bear.

Conclusion

NASCUS and state regulators have serious concerns regarding the current structure, operation, regulation and supervision of the corporate credit union system. NASCUS and state regulators are also keenly aware of, and troubled by, the extreme cost to be borne by natural person credit unions as a result of the losses in some parts of the corporate system. We reiterate that where unacceptable material risk exists, state regulators will move aggressively to set new parameters of operation and use the full breadth of their authority to enact corrective measures.

As suggested in NASCUS' comments herein, those corrective measures include re-evaluating regulatory and supervisory attitudes toward concentration limits and systemic risk. From a regulatory perspective, we remain unconvinced that arbitrarily merging away healthy corporate credit unions is the best answer. Likewise, it is not satisfactory to unilaterally declare *all* credit unions lack the technical expertise and sophistication to use complex products; to eschew the cooperative nature of the system or to force natural person credit unions outside the system for liquidity and services. Finally, it is unlikely that denying natural person credit unions the freedom of choice regarding corporates, preempting traditional state law or further homogenizing the credit union system will ultimately make the system significantly safer. We are confident it will not make the system any more viable into the future.

Ultimately, the credit union system is free to reach the above conclusions on its own. Natural person credit unions and their organizations may very well choose to initiate a movement to shrink and re-shape the corporate credit union system. That is their privilege and right. That is the marketplace. It is another thing entirely when it is done by force by the federal regulator.

Of course, regulatory action could have the same practical result. By requiring higher capital reserves and risk-based capital in corporate credit unions, enhanced risk mitigation, due diligence and contingency planning, and enforcing concentration limits, regulatory changes could cause systemic consolidation. While to some it might be a distinction without a difference, to NASCUS, the purpose of the regulation is of critical importance.

In conclusion, before restructuring the corporate credit union system, NCUA should dialogue with state regulators on improving supervision, tightening regulatory standards for risk mitigation and risk management, and leveraging the expertise from the state and federal ranks to identify systemic risk. In addition, improved modeling for information, reporting and shock testing may contribute more positively to the future viability of the system than proposed restructuring. NASCUS' approach dramatically improves oversight of the system, while retaining for the credit union system the flexibility to innovate and remain viable.

NASCUS appreciates the opportunity to comment on NCUA's ANPR. Please do not hesitate to contact me to discuss our comments further.

Sincerely,

- signature redacted for electronic publication -

Mary Martha Fortney
NASCUS President and CEO